Greenfield Advisors
Economic, Market and Valuation Analysts

The Greenfield Advisor

Issue 5-5, May, 2009

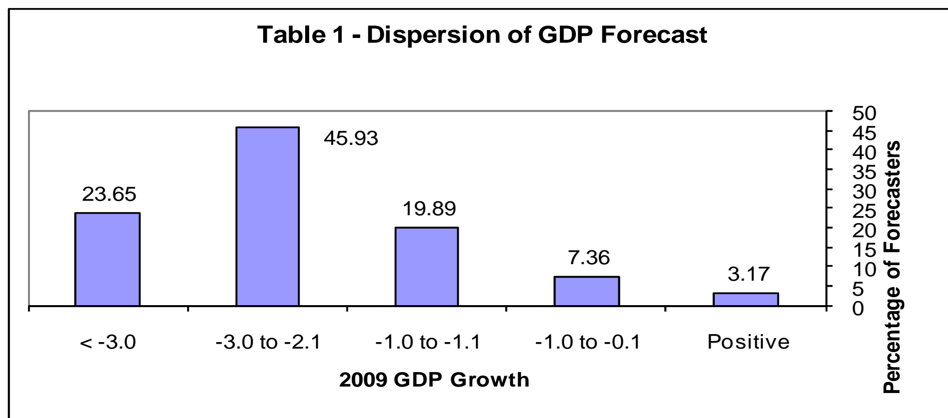
Philadelphia FED: Lower Growth, Higher Unemployment

We've mentioned before, one of our favorite economic touchstones is the quarterly Survey of Professional Forecasters (often called the "Livingston Survey") by the Philadelphia Federal Reserve Bank. They survey a panel of top economic forecasters (currently 51, although the number changes from quarter to quarter) who provide their views and expectations on the economy. The Phily-FED then compiles and reports those results, looking both at the central tendency (e.g. — the mean probabilities reported by the forecasters) as well as the dispersion of those probabilities around that central theme. Naturally, the dispersion gives a great idea of the collective confidence in the overall results; not only are we looking at the 'wisdom of crowds' but also the way crowds might hedge their collective bets.

From our perspective here at Greenfield, the most interesting facet — particularly nowadays — is to compare quarter-by-quarter results to see how many of the top professional forecasters in the U.S. are changing their opinions over time. While we admit that economic forecasting is as much art as it is science (you know what they say, "economic forecasters make tarot card readers look good"), there is probably more benefit in looking at forecasts than there is looking at historical data.

Cutting to the chase, as tough as things looked back in February when the 1st quarter report was released, the latest report is even more sour. According to the current batch of forecasts, the economy looks weaker now, with projections of lower GDP growth and higher unemployment for the remainder of this year and into next year. For 2009, the forecasters project negative GDP growth of 2.8% (down from negative 2.0% in the last forecast), and for 2010, they project that GDP will grow at an annual rate of 2.0% (down from the previous forecast of 2.2%).

As shown in Table 1, forecasters collectively only attach a 3.17% probability that GDP will actually grow this year, and but rank the likelihood that GDP could decline by worse than 3% at 23.65%



Source: Philadelphia FED and Greenfield Advisors

In the previous forecast, unemployment was projected to peak at 9.0% in the first quarter of 2010. That's now been revised upward to 9.8%. They currently project that unemployment will get better later next year, declining to an average overall annual rate of 8.7% in 2011 and 7.7% in 2012. The good news, such that there is some, is that the dispersion in opinion seems to fall to the more optimistic side, and less than 5% of forecasters think that unemployment will peak at over 11%. Table 2 (next page) summarizes the details.

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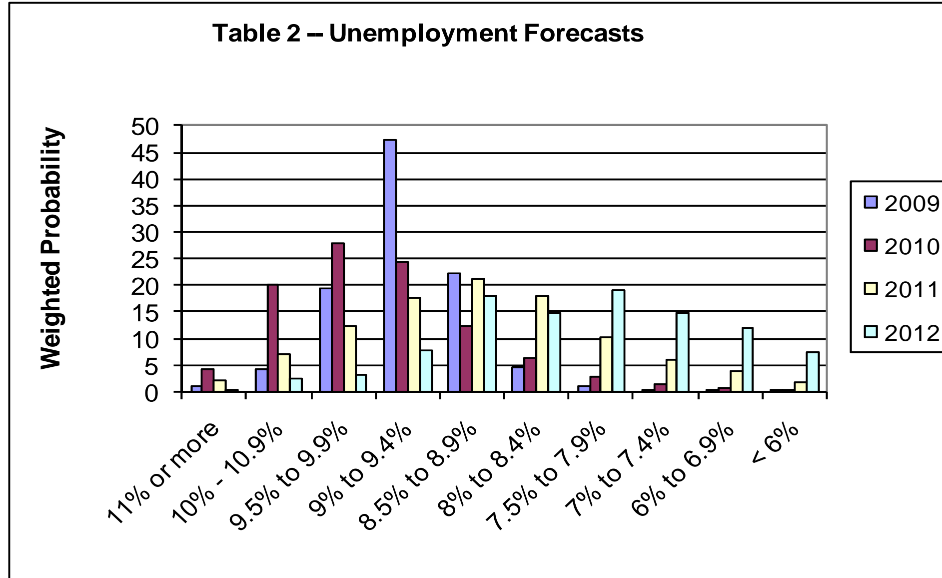
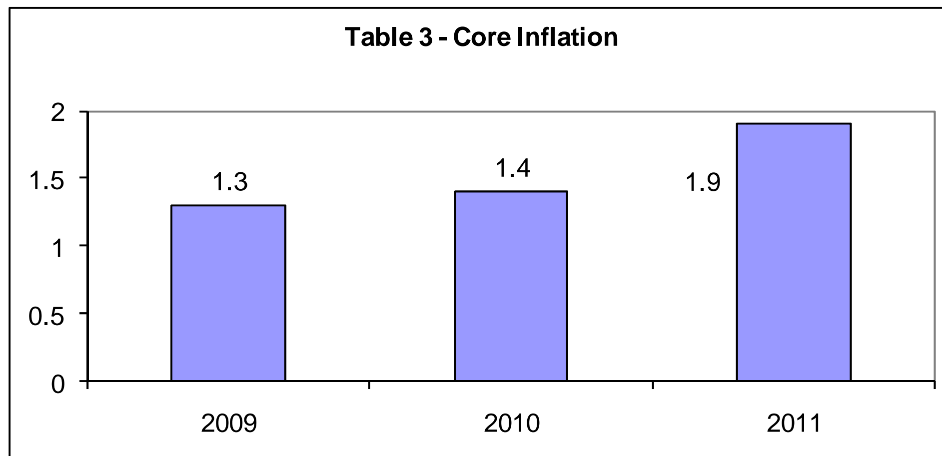


Source: Philadelphia FED and Greenfield Advisors

One implication of all of this is that inflation is basically off the table for most forecasters. In his May 29th New York Times Column, Paul Krugman (the recent Nobel Laureate in Economics), calls it the "Big Inflation Scare" (click here for a link to his column.) Quite a few pundits, including some writing at the Huffington Post, seem to think otherwise, but those attacks may be politically motivated rather than based on economic theory. The collective wisdom of the Philadelphia FED's economic forecasters is solidly on Krugman's side.



Source: Philadelphia FED and Greenfield Advisors

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So what does all this mean for Real Estate?

Of course, our primary focus here at Greenfield is real estate, which of course has been roiling during the past year. Both residential and commercial property values have been affected, albeit for significantly different reasons. To fully appreciate the implications of the Phily FED report, it's handy to reflect a bit on how and why property values have recently been impacted.

Residential Owner-Occupied Prices have declined in most parts of the country (although not all) due primarily to the unraveling of the credit markets. Both the bottom (sub-prime) and top (low-doc, executive loans, etc.) were great ideas that got widely over-used and abused. When a small increase in the foreclosure rate came along — a predictable part of every economic pull-back — the secondary market found it was over-levered in these instruments. The house of cards came tumbling down, buyers found that they had no financing, and homes that would normally easily sell (including many "distress" sales) had no financing. The market ceased to clear at "normal" prices, and prices drifted down until transactions could clear.

In appraisal terms, "prices = values" is only true for markets at equilibrium. Since current markets are not at equilibrium, yet excess demand still exists, it's highly likely that true, fundamental values are somewhere in between where prices *used* to be a year ago and where prices *are* right now. Like most economic realities, we'll have a clearer picture of this one in the rear view mirror a couple of years from now.

Commercial Property is largely immune to the same factors which affected the residential lending market, but the virtual shutdown in the credit and investment markets have caused prices to decline as well. Unfortunately, there is no excess demand for commercial real estate, and we're seeing vacancy rates rapidly rising to recession-levels. During recessions, commercial prices fall for two reasons: fundamentals decline (essentially, net rents) due to rising vacancies, and discount rates rise due to increased operating risk.

Partially offsetting the increased operating risk is, typically, the opportunity for lower interest rate financing, but with the current credit markets in an uproar, this is largely off the table. Notably, residential markets have been somewhat spoiled since the middle of the 20th century by almost continuously rising prices and values which track those prices. On the other hand, commercial values, while generally trending upward in most markets for the past 50 or so years, have more typically cycled about this trend line. Hence, commercial investors (and commercial financing) is more adept at dealing with ephemeral declines in market prices.

So where do we go from here? The Phily FED survey suggests different things for both residential and commercial property. For the residential market, the key ingredient is the inflation forecast. Housing is commonly thought of as a tax-advantaged hedge against inflation. If you can get a loan at 5%, and your marginal tax bracket is 20%, then your real cost of borrowing is 4%. If you think inflation will be 4% in the near term, then the money is free and a highly-leveraged home is an open-pit money mine. (Of course, bankers would be crazy to lend at 5% if inflation is 4%, but bankers have been known to do crazy things, haven't they?) If inflation is dead for at least the foreseeable future, then the economic rationale for buying a home starts to pale. Naturally, people will still buy homes, but the bursting of the housing price bubble has really put a damper on the eagerness to become a homeowner which permeated the market for the past 20 or so years.

Commercial markets are more affected by GDP growth and unemployment. Specifically, there's a fair amount of excess space in most geographic and sub-type markets today. Some of the "hotter" markets of recent years were, ironically, the hardest hit (Seattle and Manhattan come to mind). Apartments are probably the main exception to the rule, since the depression in home purchases will translate into demand for home rental. (The recent anomalous drop in apartment fundamentals is, among other things, the result of a lot of condo-development coming into the rental market. This should get absorbed pretty quickly.) Offices, with fairly long development pipelines, will be the next to turn around. Retail will be problematic — not only will pull-backs in the credit card market leave shopping centers high-and-dry, but the banking consolidation and some major, recent bankruptcies will dot the landscape with plenty of stand-alone brick-and-concrete boxes.

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Some News from Greenfield

First, thanks to all of you who have expressed interest in our new program, http://MyRealEstateDepartment.com. If you have any questions or inquiries about this suite of services please contact:

Christopher A. Miner, MAI
Managing Director, Real Estate Advisory Services
(206) 623-2932

Second, we'd like to report on a couple of speaking engagements, one recent and one upcoming. First, I had the pleasure of moderating a panel on "Green" investing at the May meeting of the Seattle Hedge Fund Society, held at the Harbor Club here in the Emerald City. Our panelists were:

Steve Hall, Managing Director of Vulcan Capital
John C. Siegler, Managing Director of Ridgecrest Capital Partners
Gautam Barua, co-founder of Aclaria Capital and former Deputy Controller of the State of California
Mark Townsend Cox, Founder, Managing Member, and Chief Investment Officer of New Energy Fund

It was a terrific panel, with a receptive audience who were very interested in how the spending priorities of the Obama administration will change this aspect of the investment world. My thanks go out to Jay Gould, of San Francisco office of the law firm Pillsbury Winthrop Shaw Pittman, who is the current President of the Seattle Hedge Fund Society, and particularly his assistant, Jennifer Dickinson, who really did all the heavy lifting.

Third, I'll be at the New Orleans Ritz Carlton on June 18 speaking at the Chinese Drywall Litigation Conference. This highly anticipated affair is put on by HP Litigation Conferences, formerly a part of Mealey's, with whom I've had a long relationship as a contributor. To quote from their press release:

Attorneys and experts will gather in New Orleans on June 18 to share information and network on the latest health and property damage controversy involving drywall imported from China. According to the Consumer Product Safety Commission, at least 13 states and the District of Columbia have reported "health symptoms or certain metal corrosion problems in their homes that may be related" to Chinese drywall. The CPSC said it was "moving aggressively" with the EPA and HHS to fully investigate the matter, including communication with the Chinese government. The CPSC said it has received more than 180 reports, starting with the first one on Dec. 22, 2008.

The Chinese Drywall Litigation Conference will feature chairman Bruce Steckler of Baron & Budd and a defense co-chair to be announced. Speakers include Hugh Turner of Akerman Senterfitt; Russell Nassof of TRC; Paul Phillips of Rimkus Consulting Group Inc.; Lorelie Masters of Jenner & Block; Stephen Mysliwiec of DLA Piper; Veronica Bates of Hermes Sargent Bates; Robert Horst of Nelson Levine de Luca & Horst; Burton LeBlanc of Baron & Budd; Jeremy Alters of Alters, Boldt, Brown, Rash & Culmo; Sandy Esserman of Strutzman, Bromberg, Esserman & Plifka; ***John Kilpatrick, Ph.D. of Greenfield Advisors;*** *Arnold Levin of Levin, Fishbein, Sedran & Berman; Ervin Gonzalez, Law Offices of Erving Gonzalez; Richard Lewis of Hausfeld LLP; and Patricia Williams, Ph.D., DABT, Environmental Toxicology Experts.*

For more information, or to register for the conference, please visit www.litigationconferences.com.

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